

PICS/DCPR. Nothing in the Commission's correspondence with AT&T suggests that the Commission intended to exempt any assets associated with "undetailed" investment from the Commission's basic property record and continuing property record rules. To the contrary, AT&T committed to maintaining its older manual property record system for the equipment shown as "undetailed" in PICS DCPR, and never requested a waiver of the Part 31 rules for "undetailed" equipment.

For example, the Commission did not waive Section 31, Appendix B(5)—the precursor of current Section 32.2000(f)(5)—which required companies to maintain property records in such a manner that "the property can be readily spot-checked for proof of physical existence." Nor did the Commission waive Section 31.01-2(a)—the precursor of current Section 32.12(b)—which required the detail records supporting account entries to be "readily accessible for examination by representatives of this Commission." Likewise, the Commission did not waive Section 31, Appendix B(8) – recodified in substantially similar form today as Section 32.2000(f)(8) – which required that "[a]ll drawings, computations, and other detailed records which support either the quantities or the costs included in the continuing property record shall be retained as a part of or in support of the continuing property record."

3. All Undetailed Investment Must Be Classified As Missing.

The undetailed investment must be reclassified as missing. The audit results foreclose acceptance of the RBOCs' claim that used and useful equipment actually stands behind these account entries. During the audits, none of the RBOCs could show that such assets were ever acquired or placed in service, let alone that they remain used and useful today.

This conclusion is underscored by the RBOCs' pattern of responses to other recent inquiries in this area. Whenever regulators suggest that undetailed investment may warrant scrutiny, the RBOCs scramble to write off their undetailed investment balances.

For example, when the District of Columbia Public Service Commission staff asked to see the undetailed investment claimed in the books of C&P Telephone (the precursor of Bell Atlantic-D.C.) in 1992, the company promptly removed \$26 million in undetailed investment from its books. Likewise, after preliminary audits by the Commission's Audits Branch raised similar questions about the RBOCs' undetailed investment in 1994, the RBOCs quickly removed significant amounts of undetailed investment from their books.

There is no evidence that the RBOCs found, let alone detailed, much of the equipment they retired. The vast majority of it was likely removed from the books through accounting retirements. These accounting retirements should be viewed as an admission that little if any of the undetailed investment on the RBOCs' books in the early 1990s (and before) corresponded with used and useful assets.

D. Future Audit Requirements.

The significant number of sampled items that Bell Atlantic and other RBOCs were unable to find during the audit process brings into question not only the accuracy of the RBOCs' property accounts but also the competence and integrity of the RBOCs' accounting controls. Restoring public confidence in these critical regulatory safeguards dictates thorough scrutiny of the records by expert and disinterested parties. Moreover, the process should be open to comment by all interested parties, and the audit workpapers should be available to the public, subject to appropriate protective conditions if necessary.

That a thorough audit will cost the RBOCs money (Bell Atlantic comments at 24-25) is not a legitimate objection. Even a small percentage overstatement of the RBOCs' rate bases is likely to have resulted in bilking ratepayers by hundreds of millions of dollars annually. Moreover, the need for comprehensive outside audits is entirely of the RBOCs' making, through their chronic failure to maintain their property records in compliance with the Commission's long-standing requirements.

V. OTHER ISSUES

The Commission seeks comment on the reasonableness of the auditors' interpretations of the CPR requirements. *Notice* ¶ 6. This request apparently is directed at a question raised in the separate statement of Commissioner Furchtgott-Roth: whether the "audit Staff misinterpreted the Commission's rules" by requiring "that the auditors be able to 'spot-check' the location of a company's entire equipment inventory down to a specific bay or shelf."³²

The Commission's rules provide the following:

There shall be shown in the continuing property record or in record supplements thereof, a complete description of the property records units in such detail as to identify such units. The description shall include the . . . *specific location of the property within each accounting area in such manner that it can be readily spot-checked for proof of physical existence*[.]

47 C.F.R. § 32.2000(f)(5) (emphasis added). Thus, as the audit Staff properly found, if neither the auditors nor Bell Atlantic's personnel were able to readily locate an item based on the

³² Order at 8, Separate Statement of Commissioner Furchtgott-Roth Dissenting In Part ("Furchtgott-Roth") at 8.

description contained in property records, Bell Atlantic plainly failed to comply with the Commission's rules.³³

Furthermore, the auditors did not score items as "not found" merely because the property records failed to identify the specific bay or shelf on which the item was located. As described above, the auditors followed a very generous procedure in which items were scored as not found only when, after an exhaustive search by both the auditors and Bell Atlantic's personnel, "the sampled equipment could not be located *anywhere* in the central office." BA-North Rpt. ¶ 18 (emphasis added). Thus, as even Bell Atlantic (at 21) concedes, if the item was found *anywhere* else in the central office, it either was scored as "found," or "unverified" if the incorrect location created uncertainty as to whether the item actually was the item described in CPR. BA-North Rpt., App. C at 1. Accordingly, the Commission need not be particularly concerned about such items because, in either case, no accounting adjustments were recommended for these items.

Nor is it the case that "if the auditors had determined that a company was unable to identify a particular waiting room chair that was purchased in 1994, the auditors refused to consider the fact that the records indicated that a total of 7 chairs should be present and that indeed 7 chairs were present." Furchtgott-Roth at 6-7. As the Staff report explains, regardless of whether the property records identified the correct location of the item, "[i]f the total number of

³³ Although Bell Atlantic concedes that the Commission's rules "do anticipate using the records for 'spot checks' to find the equipment," it claims that the Commission's rules "only require that the property be located 'within each accounting area,'" and that Bell Atlantic therefore only need identify the particular central office in which an item is located. Bell Atlantic at 22. That claim ignores the plain language of the rules. The Commission's rules expressly require Bell Atlantic to identify the "*specific location* of the property *within* each accounting area," not just the appropriate central office. 47 C.F.R. § 32.2000(f)(5) (emphasis added). Moreover, Bell Atlantic's argument, if correct, would render audits virtually impossible to complete.

such items at the location equaled the total number on the CPR for the office or floor, the auditor concluded that the item was *found*.” BA-North Rpt., App. C at 1 (emphasis added). Indeed, even if the auditors were shown “sufficient quantities on the frame to verify the line-item in the sample, but not to satisfy additional listings of similar equipment on the CPR that should also be on the same frame,” the item was scored as “unverified” rather than not found. This treatment was particularly favorable to Bell Atlantic because, as the Staff notes, “either the line-item equipment in the samples was missing or the other items listed on the CPR were missing In either case, there was a definite shortage on the frame.” *Id.* at 2. Nonetheless, such items were classified as “unverified,” rather than “not found,” and no accounting adjustments therefore were recommended for these items.

CONCLUSION

For the foregoing reasons, the Commission should affirm the findings of the Staff's RBOC audit reports and order appropriate corrective actions, as described herein, to remedy the RBOCs' massive overstatement of HWCOE in service.

Respectfully submitted,

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EXHIBIT A

EXHIBIT A**-- Summary of Audit Results --****TABLE 1. ESTIMATE OF PROPORTION OF HWCOE MISSING FROM THE CPR**

	Point Estimate	Standard Error	95% Confid. Interval
Bell Atlantic (South)	24.05%	0.0199	20.15% to 27.95%
Bell Atlantic (North)	20.20%	0.0198	16.32% to 24.08%
Bell South	19.50%	0.0153	16.51% to 22.49%
Ameritech	23.47%	0.0106	21.39% to 25.55 %
U.S. West	26.11%	0.0208	22.03% to 30.19%
Southwestern Bell	21.27%	0.0194	17.47% to 25.07%
PAC/Nevada Bell	19.06%	0.0178	15.57% to 22.55%

TABLE 2. ESTIMATE OF VALUE OF HWCOE MISSING FROM THE CPR

	Point Estimate (millions)	Standard Error (millions)	95% Confid. Interval (millions)
Bell Atlantic (South)	\$805	\$183	\$448 to \$1,164
Bell Atlantic (North)	\$382	\$77	\$230 to \$533
Bell South	\$292	\$73	\$149 to \$435
Ameritech	\$306	\$53	\$203 to \$ 409
U.S. West	\$379	\$101	\$181 to \$576
Southwestern Bell	\$222	\$59	\$105 to \$338
PAC/Nevada Bell	\$499	\$110	\$283 to \$716

EXHIBIT B

APPENDIX B

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matters of:

Ameritech Corporation Telephone Operating
Companies' Continuing Property Records
Audit

Bell Atlantic (North) Telephone Companies'
Continuing Property Records Audit

Bell Atlantic (South) Telephone Companies'
Continuing Property Records Audit

BellSouth Telecommunications' Continuing
Property Records Audit

Pacific Bell and Nevada Bell Telephone
Companies' Continuing Property Records
Audit

Southwestern Bell Telephone Company's
Continuing Property Records Audit

US West Telephone Companies' Continuing
Property Records Audit

CC Docket No. 99-117

ASD File No. 99-22

REPLY COMMENTS OF AT&T CORP.

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REPLY COMMENTS OF AT&T CORP.

Pursuant to the Commission's *Notice*¹, AT&T Corp. ("AT&T") hereby submits its reply comments concerning the accounting practices of the captioned companies, and the issues arising from the audits of their hard-wired central office equipment ("HWCOE") by the Common Carrier Bureau Staff ("Staff"). These reply comments, like AT&T's initial comments, are preliminary. Only Bell Atlantic has permitted the Commission to allow examination of the work papers underlying the Commission and RBOC analyses of the audits to AT&T and other interested parties. While Ameritech has disclosed a small subset of its underlying documentation, the items disclosed are so selective and heavily redacted as to be virtually unintelligible. And the other holding companies that challenge the Commission's audit results – BellSouth, Pacific Bell/Nevada Bell, Southwestern Bell and U S WEST – still refuse to permit others to inspect the property records and other work papers needed to test their criticisms of the audit results.

INTRODUCTION AND SUMMARY

The initial comments of the Regional Bell Operating Companies ("RBOCs") offer no legitimate challenge to the central finding of the Commission's audit Staff: literally *billions* of dollars of investment on the RBOCs' books reflect equipment either never placed in service or long since retired. The centerpiece of the RBOCs' September 23 comments—the testimony of the accounting firms hired by the RBOCs' to "rescore" the CPR entries found missing by the

¹ Notice of Inquiry, *Ameritech Corporation Telephone Operating Companies' Continuing Property Records Audit*, 14 FCC Rcd. 7019 (1999).

audit Staff—is little more than an extravagant public relations gambit. The accountants' reports are essentially black boxes. Almost none of the source documents purportedly relied on by the accountants in reenacting the audits have been released to the public. Hence, the accountants' results can be neither tested nor replicated. What little information can be discerned about the rescoring indicates that the accountants' rescoring judgments were extremely overgenerous to their RBOC clients. Even so, the accountants' reports confirm that most of the items found missing by Staff were actually missing.

The RBOCs' assault on the sampling procedures underlying the audits remains without substance. The stratified sampling procedures were designed by accounting and statistical experts on the Commission's Staff, adhered to widely used and generally accepted sampling practices, and were reasonably calculated to produce accurate and reliable results. The RBOCs again have failed to show that any of the alleged flaws in the sample design have—or are likely to have—any material effect on the results obtained by the audit Staff. The only plausible inference from the RBOCs' continued failure of proof is that the effects of the supposed sampling errors are immaterial, or that the samples *understate* the overall percentage of HWCOE that is missing.

The RBOCs' critiques of the audit scoring and rescoring procedures are equally misguided. Even the RBOCs admit that they cannot find many of the items selected for verification. Moreover, any bias in the scoring standards was in the RBOCs' favor. The audit Staff bent over backwards to enable the RBOCs to show that items on the companies' books actually remained in service, and even scored items as "unverified" that should have been reported as missing. The RBOCs' criticisms of the rescoring procedures amount to little more

than dissatisfaction that the audit Staff declined to accept on faith all of the RBOCs' post hoc speculation about the location of the missing assets.

The RBOCs' criticisms of the statistical point estimates and confidence intervals obtained by the audit Staff are also without merit. None of the RBOCs offer a legitimate reason for basing the estimated value of missing equipment on the lower (or, conversely, the upper) end of the confidence interval rather than the point estimate. In any event, the RBOCs have grossly overstated the breadth of the relevant confidence interval. The *reducto ad absurdum* of the RBOCs' statistical arguments is their claim that the bottom of the confidence interval is below zero—a logical impossibility.

The only options lawfully open to the Commission are reducing the RBOCs' rate bases by the share of phantom assets (and requiring related adjustments to the RBOCs' books), or sponsoring a full-blown audit of each RBOC (and requiring similar audits in the future). The Commission cannot simply sweep the evidence under the rug, as the RBOCs seek. The evidence strongly indicates that the RBOCs have maintained inflated books (either willfully or through neglect), and are collecting millions of dollars of windfall annually as a result.

ARGUMENT

I. THE STANDARD SAMPLING TECHNIQUES EMPLOYED BY THE STAFF WERE VALID AND PROPER.

The RBOCs' September 23 comments on the sampling techniques underlying the audits are insubstantial.² As AT&T explained in its opening comments, the Staff's statistical sampling plan for estimating the proportion and value of missing HWCOE was a textbook application of two-stage stratified sampling, a rigorous, flexible, and cost effective method of accurately estimating the characteristics of large populations of varying size.³ By implementing the two-stage stratification design, the Staff was able to collect more information and data for a given cost than it would have been able to collect using an alternative design.⁴ For this reason, the Staff obtained more reliable estimates, in the sense of lower variance for a given cost, than the estimates that could have been obtained using other sampling procedures.⁵ The RBOCs'

² Notice of Inquiry, *Comments of BellSouth* at 13-14, CC Docket No. 99-117, ASD File No. 99-22 (Sept. 23, 1999) ("BellSouth Comments"); Notice of Inquiry, *Bell Atlantic Comments* at 3, CC Docket No. 99-117, ASD File No. 99-22 (Sept. 23, 1999) ("Bell Atlantic Comments"); Notice of Inquiry, *Comments of Southwestern Bell Telephone Company, Pacific Bell and Nevada Bell* at 7-9, CC Docket No. 99-117, ASD File No. 99-22 (Sept. 23, 1999) ("SBC Comments"); Notice of Inquiry, *Comments of US WEST* at 5-8, CC Docket No. 99-117, ASD File No. 99-22 (Sept. 23, 1999) ("US WEST Comments"); Notice of Inquiry, *Comments of Ameritech* at 10-12, CC Docket No. 99-117, ASD File No. 99-22 (Sept. 23, 1999) ("Ameritech Comments").

³ For a complete discussion of the benefits of two-stage stratification procedures, see Notice of Inquiry, *Comments of AT&T Corp.* at 7-9, CC Docket No. 99-117, ASD File No. 99-22 (Sept. 23, 1999) ("AT&T Comments"). See also *id.* Exh. A, ¶ 1 ("Bell Aff."); Notice of Inquiry, *Comments of Eliot Spitzer, Attorney General of The State of New York* at 2-4, CC Docket No. 99-117, ASD File No. 99-22 (Sept. 23, 1999) ("New York Comments") ("the audit appears to have been carried out with thoroughness and rigor"); William Cochran, *Sampling Techniques* 292-318 (3d ed. 1977) ("Cochran"); Paul S. Levy & Stanley Lemeshow, *Sampling of Populations: Methods and Applications* 121-89 (1999) ("Levy").

⁴ See AT&T Comments at 8; Reply Affidavit of Dr. Robert Bell at ¶¶ 7-8 ("Bell Reply Aff.") (attached hereto as Appendix A).

⁵ See Bell Reply Aff. ¶ 7.

criticisms of the survey design provide no basis, either individually or collectively, for rejecting the audit results as unreliable or biased.

A. A “One-Way Audit” Was Proper.

As AT&T explained in its September 23 comments, the Staff’s decision to conduct a one-way audit rather than a two-way audit provides no basis for assuming away the problem of unrecorded HWCOE. The RBOCs have ample incentive to include every piece of HWCOE in the CPR because those records can have a significant effect on the RBOCs’ rate base, depreciation rates and other important ratemaking determinants.⁶ Moreover, only the RBOCs have access to the information needed to prove or disprove the existence of unrecorded information; it is telling that they have provided no such information. AT&T Comments at 11-12.

The RBOCs’ September 23 comments on the two-way audit issue merely underscore the pretextual nature of their criticisms. Southwestern Bell, while asserting that it once found \$120 million of HWCOE not listed in its CPR, offers no documentation or evidence that would allow anyone to test or verify this claim. SBC Comments at 7. The other RBOCs do not even *assert* that they have ever had significant amounts of unrecorded HWCOE.

⁶ See Part IV., *infra*.

B. No Material Bias Occurred.

The RBOCs claim that the audit designs suffer from “potential” sources of bias,⁷ but fail to provide an iota of evidence that any material bias has actually occurred. Indeed, where the potential existence of bias is testable, the RBOCs’ own experts agree that the magnitude of the bias is negligible and that the direction of any potential bias is indeterminable.⁸

Statistical Bias. Several RBOCs note that the estimators used by the Staff in theory could suffer from statistical bias.⁹ Even the RBOCs’ own experts concede, however, that the magnitude of such bias is negligible.¹⁰ Moreover, the direction of any such bias is indeterminable, *i.e.*, it is equally likely that any bias *lowered* the Staff’s estimates of the proportion and value of missing HWCoe. Finally, and most importantly, the scientific community prefers the highly accurate estimates used by the Staff over alternative unbiased, but less accurate, estimates. *See* Bell Reply Aff. ¶ 16.

Use Of Multiple Audit Teams. The RBOCs’ continued insistence that the Staff’s use of multiple audit teams somehow biased the Staff’s estimates is a makeweight.¹¹ It is common practice to employ multiple audit teams in a project as vast as the one undertaken by the Staff;

⁷ *See, e.g.*, Ameritech Comments at 10-11; SBC Comments at 6 & Exh. A at 12-16; BellSouth Comments at 14-15 & Exh. 3, at 4-5; Bell Atlantic Comments at 3; Ex Parte Letter From Arthur Andersen, PricewaterhouseCoopers, and Ernst & Young at 1, filed Sept. 22, 1999.

⁸ SBC Comments, Exh. A at 12-16; BellSouth Comments, Exh. 3, at 4; Notice of Inquiry, *Response to Audit Staff Draft Report of Findings Related to Audit of Continuing Property Records of Bell Atlantic*, Exh. 2, at 5, CC Docket No. 99-117, ASD File No. 99-22 (Sept. 23, 1999) (“Bell Atlantic Response”).

⁹ *See, e.g.*, BellSouth Comments, Exh. 3, at 4; SBC Comments, Exh. A at 12-16; Bell Atlantic Response, Exh. 2, at 4.

¹⁰ *Id.*

¹¹ *Id.*

indeed, the notion that a professional auditing firm would use only one audit team to conduct audits at more than 250 central offices is ludicrous. Each Staff team operated with identical written forms that they were trained to complete in an accurate and consistent manner. The consistency of the teams' findings was further ensured by back-at-the-office comparisons. And each audit team was accompanied by RBOC personnel who served as an additional check on the actions of the Staff auditors. If anything, Staff's use of multiple audit teams actually *reduced* the potential for bias by ensuring that faults in any individual team's execution of the audit procedures could not prejudice the results of the entire audit.

Exclusion of Very Small Or Remote Offices. The RBOCs' continued claim that bias resulted from the Staff's exclusion from the samples of very small offices (those with fewer than 100 CPR line items) and inaccessible offices remains meritless.¹² As AT&T has noted, excluding particular offices can introduce bias only if both of two conditions hold: (1) the proportion of missing items in those offices differs greatly from the proportion in larger offices; and (2) a substantial proportion of all items were in those offices. AT&T Comments, Att. 1, ¶¶ 18-19 ("Bell Aff.").¹³ The RBOCs continue to offer no evidence that either condition holds. See Bell Reply Aff. ¶ 31.

There is no *a priori* reason to believe that small or relatively inaccessible offices would have relatively less missing equipment than the average office in the RBOC's universe. Resolving this issue as a factual matter requires information that the RBOCs alone control. Their

¹² For Bell Atlantic North/NYNEX and Bell Atlantic South, the audits even included offices containing fewer than 100 CPR items.

¹³ See also AT&T Comments at 9-10.

failure to produce this information warrants the inference that the unsampled offices have at least as high (if not a higher) percentage of missing HWCOE as the sampled offices.

There is likewise no *a priori* reason to expect the excluded offices to represent a large share of the total population of HWCOE. In fact, the opposite is true: large offices “house the lion’s share of all RBOC hard-wired . . . equipment.” Bell Aff. ¶ 13. Nor is there any reason to believe that the few excluded out-of-the-way offices hold a particularly large share of the total population of HWCOE.

In all events, at a minimum, the Staff’s audit clearly indicates that the central offices that were included as potential candidates for an on-site visit—*i.e.* the central offices with more than 100 units of HWCOE—are missing significant amounts of HWCOE valued in the hundreds of millions of dollars. Thus, the RBOCs’ arguments that the Staff’s statistical results should be disregarded because of the Staff’s practical considerations are devoid of any basis in fact or logic.¹⁴

¹⁴ The RBOCs’ claim that the Staff has injected significant bias by sampling equipment at a central office in North Carolina is also without merit. *See, e.g.*, BellSouth Comments at 15. As the Staff have explained, an office in North Carolina was randomly selected simply “to ensure that every state was represented.” BellSouth Rpt., App. B at 6. Moreover, the inclusion of the North Carolina office can only affect the Bellsouth audit. The extent of any affect on the BellSouth office can easily be measure by the Staff and corrected for. Bell Reply Aff. ¶ 33-36. In any event, the RBOCs have offered no evidence that the North Carolina office had a higher percentage of phantom investment in its CPR than the average BellSouth office, or the average of the BellSouth offices sampled by the audit staff. *Id.*

C. The Staff Properly Computed Estimates Using Gross Book Value of Missing HWCOE.

The RBOCs assert that the estimates of missing HWCOE are exaggerated because the Staff used the gross book value of the missing items rather than the net value of those items.¹⁵ As an initial matter, because the Commission contrasts the quantity of missing plant to the gross quantity of such plant maintained on the RBOCs' books, it is only consistent to use the gross book value of this missing plant. Moreover, the RBOCs have failed to show that any of the HWCOE listed in the CPR but missing from the central offices during the audits was *ever* put in service. In light of the RBOCs' failure of proof, Staff's decision to value the missing HWCOE at its non-depreciated – *i.e.*, book – value was the only reasonable course. In any event, if a RBOC uses a pooled depreciation method, a retirement is recorded by debiting and crediting the asset cost to accumulated depreciation and cost, respectively. Hence, the gross asset value (cost) is the appropriate figure to estimate.

D. The Staff Properly Stratified By Central Office Size.

The RBOCs contend that the accuracy of the Staff's estimates would have been improved by "stratify[ing] the line items by in-place cost within the selected locations." BellSouth Comments, Exh. 3, at 3 n.2.¹⁶ As AT&T has previously explained, this strategy could narrow the existing confidence intervals *only* if the distribution of cost for sampled items differed significantly from the population as a whole.¹⁷ But, as noted by Chairman Kennard, Staff's

¹⁵ SBC Comments at 12.

¹⁶ See also SBC Comments at 2 & Exh. A at 4; US WEST Comments at 5-6 & Att. 1 at 2-3 & Att. 2 at 8; Bell Atlantic Comments at 3; BellSouth Comments at 13-14.

¹⁷ Bell Aff. ¶ 16-17.

stratification method ensured a “representative sample of high, medium, and low value items from all sizes of central offices.” Letter from Chairman Kennard, FCC, to Reps. Tauzin and Dingell, Committee on Commerce at 6 (Feb. 24, 1999) (“Chairman’s Letter”). That is, the sample collected by the Staff has essentially the same proportion of expensive and inexpensive items as actually exist among all central offices. Chairman’s Letter at attached graph (entitled *CPR Audits, Percentage of Records By Dollar Range Comparison of Population and Sample BOC Total*). Thus, the additional stratification suggested by the RBOCs would have been superfluous. Bell Aff. ¶ 17 (“claims . . . that the FCC Staff should have performed additional stratification merit no weight”).

Moreover, the Staff expressly accounted for the differences in the average cost of missing items relative to the average cost of all items in the population. As noted by Chairman Kennard, if “mostly low-cost items were missing, the projected missing amount would be relatively low in comparison to the projection if relatively high-cost items were missing.” Chairman’s Letter at 7. The “average cost per missing items was generally 80 percent [lower than] . . . the average of all cost for all plant.” *Id.* The Staff adjusted its projections to reflect this difference, thereby significantly *lowering* the Staff’s projections. *Id.*

E. The Staff Properly Audited Items of All Costs.

Certain RBOCs assert that the Staff should have excluded HWCOE valued at less than \$2,000 from the audits because “[m]icromanagement” of such investment is contrary to the “procompetitive deregulatory policy framework” of the 1996 Act. Ameritech Comments at 30 & Att. A at 15. The Commission’s regulations, however, provide no record-keeping exceptions for items valued below \$2,000. Moreover, items below the \$2,000 threshold are extremely

important to record accurately, because they collectively account for a vast amount of the RBOCs' HWCOE.¹⁸ Exempting CPR entries below the threshold from regulatory oversight would inflict a massive breach in the integrity of the CPR as a safeguard for captive ratepayers.

II. THE AUDIT SCORING PROCEDURES WERE REASONABLE AND, IN FACT, OVERLY GENEROUS TO THE RBOCs.

The RBOCs' continued assault on the audit staff's standards and procedures for scoring and rescoreing the missing items is an inversion of reality. If the Staff's scoring and rescoreing procedures suffered from bias, the bias was in the RBOCs' favor. For example, notwithstanding that the RBOCs received ample notice and time to prepare for the audits and that the audit Staff remained at each central office until the RBOCs' own personnel agreed that missing items could not be found, the RBOCs were given *four* subsequent opportunities to provide credible evidence that the missing equipment had in fact been "found." When the RBOCs provided some evidence of an item's existence, but the evidence was less than fully persuasive, the Staff frequently scored the item as "unverified" rather than "not found," and thus created a large category of items for which accounting adjustments likely should have been recommended in the report, but were not. The RBOCs were asked to provide explanations and documentation showing that certain items initially classified as "unverified" or "not found" should have been reclassified as "found," but were not asked to provide documentation that would have allowed the Staff to conclude that certain items classified as "found" or "unverified" should have been classified as

¹⁸ Ameritech Comments at 30 (citing Ameritech Comments, Att. A at 15) ("over one third [of the sampled items] were valued under \$2,000").

“not found.” As a result, the vast majority of rescored items (80 percent, in the case of Bell Atlantic) were rescored in the RBOC’s favor. When viewed against this background, the RBOCs’ claims of unreasonableness simply ring hollow. *See, e.g.,* New York Comments at 4, 6 (“the audit appears to have been carried out with thoroughness and rigor” and the RBOCs’ contrary “arguments are unconvincing”).

The RBOCs respond that their own accounting firms have given them a clean bill of health.¹⁹ The Commission can lawfully give no weight to these reports, because the RBOCs continue to withhold approval to release the data needed by AT&T and other third parties to test and verify the propriety of most of the scoring changes advocated by the RBOCs. Moreover, what little data the RBOCs have produced make clear that their hired auditors’ rescoring determinations are questionable or facially incorrect. The auditors’ labors merely underscore that unverifiable audit reports are no substitute for subjecting the RBOCs’ claims to testing through discovery and rebuttal testimony by other interested parties.

A. The RBOCs Received Ample Notice And Time To Prepare For Their Audits.

The Commission’s rules put the RBOCs on permanent notice that they are required to maintain, on an on-going basis, updated descriptions and locations of each of their in-service plant assets so that the equipment may be readily spot-checked for proof of physical existence. 47 C.F.R. § 32.2000(f)(5). As the Attorney General of the State of New York states, “[t]he FCC’s regulations clearly require that each telephone company maintain its continuing property

¹⁹ *See* BellSouth Comments Exh. 1 & Exh. 3; SBC Comments, Exh. A & Exh. 2; US WEST Comments Exh. A & Exh. B.

records in a complete, accurate, and up to date fashion so as to facilitate just the kind of audit under review here.” New York Comments at 6-7. In addition, the Staff expressly informed the RBOCs that such audits would be performed, and even provided them with advance notice of the locations that would be audited. *See, e.g., Audit of the Continuing Property Records of the NYNEX Telephone Operating Companies Also Known As Bell Atlantic North As of March 31, 1999*, ¶ 18 (FCC Dec. 22, 1998) (“BA-North Rpt.”). Staff also informed the RBOCs that they could line up any resources they deemed necessary to locate any items contained in the CPR, and expressly requested the assistance of RBOC personnel familiar with the equipment and offices to be audited. *Id.* Accordingly, “there was ample warning and opportunity for [the RBOCs] to bring [their] continuing property records into compliance with the FCC’s rules,” New York Comments at 7, and the RBOCs have no legitimate excuse for their failure to locate a significant number of sampled items at the time of the on-site inspection.

B. The On-Site Inspections Were Conducted In A Highly Professional Manner.

The comments likewise confirm that the on-site inspections were conducted in a highly professional manner.²⁰ The Staff’s procedures were field-tested in advance of the actual field visits, RBOC personnel supported the Staff’s verification process at each location, and RBOC personnel were given an unlimited opportunity to locate equipment elsewhere within an office when the equipment was not found at the location indicated by the CPR. *See AT&T Comments*

²⁰ *See, e.g., MCI Comments* at 7 (“the audits were planned and conducted in a professional manner.”); *New York Comments* at 4 (“the audit appears to have been carried out with thoroughness and rigor . . .”).

at 16-18. All of this on-site audit work was well-supervised and reviewed, and the Staff's workpaper documentation was clear, concise, consistent, and complete. *Id.* at 18. Accordingly, there is no reasonable basis for disparaging the reliability of the audit Staff's workpapers or the initial scorings. And, as the Florida PSC notes, "the results indicate there are problems in [the RBOCs'] CPRs worthy of corrective action." Notice of Inquiry, *Comments of the Florida Public Service Commission* at 2, CC Docket No. 99-117, ASD File No. 99-22 (Sept. 23, 1999) ("Florida Comments").

The RBOCs' claim that the Staff's on-site audit procedures were overly restrictive is wholly unsupported. The RBOCs allege that the audit Staff allowed only six hours to physically inspect each office, and thus had an average of only 10 minutes to search for each of the 36 sampled items.²¹ This allegation is false in several respects. First, the auditors' visits were not limited to six hours. Rather, the auditors remained at each central office location until the RBOCs' *own personnel* agreed that the missing items could not be found and that a exhaustive search for the sample items had been performed. Loebbecke Reply Aff. ¶ 9. Second, each team of auditors visiting a central office was split into two groups, each of which was assigned to cover only 18 sampled items per day, and thus had, on average, well above 20 minutes to search for each of the sample items. Third, the RBOCs' own personnel also assisted in the search, and thus further increased the Staff's ability to rapidly locate the sampled items. Fourth, to the extent the RBOCs' CPR records accurately identified the location of a sampled item, that item was found almost immediately, thus leaving significant amounts of extra time to locate the hard-to-

²¹ *Id.*

find/missing items. In short, the RBOCs were given a virtually unlimited opportunity to locate the sampled equipment, and simply failed to do so.

In addition to concocting nonexistent limitations on the competence and working time of the audit Staff, the RBOCs also ignore the heavy bias in their favor produced by the Staff's standards for initial scoring during the on-site inspection. The standards for classifying an item as "not found" were very stringent: items were considered not found only when, after an exhaustive search by both the auditors and RBOC personnel, "the sampled equipment could not be located *anywhere* in the central office." BA-North Rpt. ¶ 18 (emphasis added). By contrast, an item was classified as "unverified" if the auditor had some reason to believe, but was uncertain, that an item had been located. BA-North Rpt., App. C at 1-2 (Problems Encountered In The Verification Process). As Professor Loebbecke explains, this scoring system gave the RBOCs the benefit of the doubt by classifying a large number of items that could not be verified with certainty as "unverified" rather than "not found." AT&T Comments, Exh. C, ¶ 11 ("Loebbecke Aff."). And because a significant fraction of the "unverifiable" items are likely to be missing, and should have been scored as "not found," the tallies of "not found" items in the audit reports imply a significant underestimate of the total dollar amount of missing equipment. *Id.*

The procedures used by the Staff to conduct the audit, the comprehensive and clear reports issued by the Staff to explain exactly what statistical procedures were applied to the data, and the Staff's repeated requests for comment from the RBOCs on the audit procedures also speak well of the Staff's professionalism. What is unprofessional is the RBOCs' strategy of criticizing the Staff's survey design and scoring decisions while refusing to disclose information

in the RBOCs' exclusive possession that the Staff and interested third parties would need to determine the legitimacy (if any) of the RBOCs' criticisms.

C. The Staff's Rescoring Procedures Were Reasonable.

The other parties' initial comments further demonstrate that the Staff's rescoring procedures were reasonable.²² Despite the RBOCs' obligation under the Commission's rules to maintain accurate CPR records so that the equipment may be readily spot-checked for proof of physical existence, the Staff gave the RBOCs *four* additional opportunities after the on-site inspections to document the location of items tentatively scored as "not found." Incredibly, notwithstanding these numerous opportunities, RBOCs, like Bell Atlantic, claim that they "had no opportunity to undo the damage of [the] initial inspections." Bell Atlantic Comments at 6. To the contrary, the RBOCs were afforded numerous such opportunities, yet they failed to provide persuasive evidence of the existence of a significant number of missing items. Accordingly, the Staff properly scored these items as "not found."

1. The Staff Carefully Considered The RBOCs' Post-Audit Submissions.

The RBOCs' principal complaint is that their post-inspection explanations and documentation were essentially ignored by the Staff, and that the Staff did little more than shuffle around the categorizations of a few items without making any substantial changes. *See, e.g.,* Bell Atlantic Comments at 6 ("The bulk of the evidence that Bell Atlantic subsequently uncovered and presented to the FCC staff was either ignored or rejected."); SBC Comments at

²² *See, e.g.,* MCI Comments at 14 ("the rescoring process favored the RBOCs"); New York Comments at 7.

16-17 (“[D]ocumentation was apparently not fully taken into account [by the Staff]. The [auditors] changed very few items to a found designation based on additional supporting documentation.”) (quoting Ameritech Response at 5). This complaint, however, is utterly baseless. The Staff gave careful consideration to *all* of the RBOCs submissions “and made appropriate adjustments as warranted.” BA-North Rpt. ¶ 20. *****BEGIN BELL ATLANTIC PROPRIETARY***]**

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ATLANTIC PROPRIETARY*]** Thus, contrary to the RBOCs’ suggestion, the Staff did not ignore the RBOCs submissions; it merely found that some of the RBOCs’ after-the-fact “documentation” provided an insufficient basis for rescoring certain items originally classified as “not found.”

2. The Staff’s Rescoring Standard Was Reasonable.

The RBOCs also contend that the Staff’s rescoring standard was unreasonable. Specifically, the RBOCs allege that Staff’s rescoring was characterized by “[a] nearly exclusive reliance on physical inspection as the only competent evidential matter considered.” Ameritech Comments at 13; *see also, e.g.*, Bell Atlantic Comments at 6. Heavy reliance on the initial physical inspection is entirely proper in this context because the inspection was conducted with such rigor and is the most reliable safeguard against phantom costs and inaccurate books. Loebbecke Reply Aff. ¶ 18.

Moreover, the RBOCs' allegation significantly overstates the stringency of the Staff's rescoring standard. As the Staff has explained, "[t]he basic standard that companies were required to meet in order to have an item re-scored was to provide adequate and convincing evidence that the facts were different than appeared at the time of the auditors' on-site inspection."²³ Such "adequate and convincing evidence" included "relevant source documentation and engineering drawings." *Id.*

For example, "[i]f the company provided original invoices showing that only 4 units had been installed and the equipment descriptions, dates of purchase, and costs stated on the invoices matched the information on the CPR, the auditors determined that the evidence was probative . . . and that a re-scoring . . . was warranted." *Id.* Even when the company failed to provide such source documentation, if the Staff was able to determine that "the recorded cost [in the CPR] fully appeared to support a lesser quantity than recorded, the auditors generally rescored the 'not found' designation." *Id.* Similarly, "[i]f the company . . . provided evidence (*e.g.*, an engineering drawing or a manufactured schematic) demonstrating that [an item could not be seen because it was embedded in another item], the auditor classified the item as 'found')." *Id.* Indeed, even if *no* evidence was provided to support the RBOC's claim that the item was embedded, the item "remained scored as 'unverified.'" *Id.* Thus, contrary to the RBOCs' assertions, they were able to obtain a rescoring of an item merely by submitting relevant

²³ Public Notice at 2, *The Accounting Safeguards Division Releases Information Concerning Audit Procedures For Considering Requests By The Regional Bell Operating Companies To Reclassify Or "Rescore" Filed Audit Findings Of Their Continuing Property Records*, DA 99-668 (Apr. 7, 1999) ("*Rescoring Report*").

supporting documentation and, as described above, a significant number of items were in fact rescored based on that documentation.

A more lenient rescoring standard would have been completely inappropriate. Florida Comments at 4-5 (Staff's rescoring standard was "reasonable"); New York Comments at 7 (rejecting Bell Atlantic's "post-audit attempt to rehabilitate its deficient continuing property records"). As described in AT&T's initial comments, the auditors became familiar with the layout and equipment at each inspection site, and thus were in a unique position to judge the credibility of the RBOCs' explanations and documentation. Moreover, the searches were conducted jointly with RBOC personnel, who presumably were both knowledgeable and motivated to find the requested equipment. And, as described above, the Staff's *initial* scoring was very lenient – allowing potentially missing items to be classified as "unverified" even though Staff could not reasonably determine whether the items shown to the auditors were the actual items listed on the CPR. Against this background, the Staff reasonably required a persuasive showing of evidence before rescoring items initially classified as "not found."

3. Much Of The RBOCs' Alleged "Documentation" Was Insufficient Under Any Reasonable Standard.

In any event, much of the RBOCs' proffered post-inspection "documentation" was insufficient, under any reasonable standard, to persuade an experienced auditor to discount the validity of his or her eyewitness inspection and determine that the missing equipment had been found. Indeed, this conclusion is confirmed by the RBOCs' own accounting firms, who have determined that a significant amount of equipment listed in the CPRs is in fact missing. When the RBOCs' own accountants fail to find items for which the RBOCs have submitted

documentation purportedly establishing that the items exist, the validity of the documentation is plainly called into question.

The RBOCs again simply misrepresent the Staff's procedures for scoring an item as "not found." Contrary to the RBOCs' assertions, items found in other locations, items with no location information at all, items retired between the date of the sample report and the physical verification, items embedded in other items, and items affected by CPR misstatements were *not* scored as missing. Instead, all of these items either were scored as "found" or "unverified," and thus no accounting adjustments were recommended for such items.²⁴

Furthermore, the Staff's *Rescoring Report* (at 2-4) demonstrates that the Staff rejected the RBOCs' documentation evidence only when, in the Staff's experienced professional judgment, the evidence did not provide a reasonable basis for rescoring the items. For example, "auditors did not find source documentation sufficient where the information on the invoices did not match the descriptions and/or the costs of the equipment listed in the CPRs." *Id.* at 2-3. And "where the companies provided non-source documentation, *e.g.*, internal documents that were not contemporaneous with the equipment purchase or installation, the auditors generally found the evidence was inadequate." As the Florida PSC notes, this approach is eminently reasonable. Florida Comments at 4-5. "[S]ource documents that contain cost amounts, signatures, dates, and other information offer the most convincing evidence relative to the installation and removal of equipment." *Id.* at 4. Thus, "[i]f an original invoice matched the CPR as far as dates of purchase, description of equipment, and costs but the number of units varied, it appears reasonable for the auditors to conclude that rescoring would be appropriate." *Id.* If, however,

²⁴ See, *e.g.*, BA-North Rpt. ¶ 21 & App. C.

“the source documentation did not match the descriptions and costs listed in the CPR, it seems reasonable that the auditors would not rescore.” *Id.* As the Staff properly determined, “documentation without authorizing signatures or dates of removal is not considered adequate documentation.” *Id.* at 5.

Under these reasonable standards, the Staff rejected RBOC documentation that, for example, consisted of an “invoice[] demonstrating only that an item had been purchased” with no additional “proof that an interim removal or retirement had occurred.” *Rescoring Report* at 3. In other cases, the Staff rejected evidence showing “that a retirement or removal had occurred, but “no further documentation or evidence . . . that reflected dates of removal or authorizing signatures.” *Id.* The Staff’s decision to reject such patently insufficient evidence was plainly reasonable, Loebbecke Reply Aff. ¶ 20, and neither the RBOCs nor their accounting firms provide any explanation as to why such evidence should have been deemed sufficient.

Professor James K. Loebbecke, a distinguished scholar and practitioner of auditing, has reviewed the Staff’s scoring and recording procedures with respect to several sampled items that the Staff declined to rescore for Bell Atlantic, the one carrier to permit third-party review of a significant amount of source documentation. Professor Loebbecke’s analysis confirms that the Staff’s scoring decisions were entirely reasonable.

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